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No. 512

Supreme Court of the United States

CLIFTON E. BAIRD and VIOLET L. BAIRD,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

BRIEF FOR THE PETITIONERS

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Opinions Below

The Findings of Fact and Memorandum Opinion of the Tax Court (R. 43-54) are not officially reported. The opinion of the Court of Appeals for the Seventh Circuit (R. 74-86) is reported at 256 F.2d 918.

Jurisdiction

The judgment of the Court of Appeals was entered on June 20, 1958. (R. 87) The time for filing the petition for a writ of certiorari was extended to and including November 17, 1958. (R. 88) The petition for a writ of certiorari was filed on November 12, 1958, and was granted on December 15, 1958. (R. 88-89) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether amounts withheld upon assignment of installment contracts and credited by finance companies to an account designated "Dealer Reserve" in the name of petitioners, accrual basis taxpayers, are taxable as income in

the tax year when credited or in the tax year when the petitioners have the right to receive payment.

Statute and Other Authorities Involved

Printed in the Appendix, *infra*, pp. 34 through 36, are Sections 22(a), 41 and 42(a) of the Internal Revenue Code of 1939 and Treasury Regulation 118, Sections 39.41-1 and 39.41-2(a).

Statement

The sole issue in controversy involves the correct amount of accruable income for each of the taxable years 1952, 1953 and 1954 under contractual agreements between a partnership (composed of the petitioners) and three finance companies with which the partnership did business in those years. More specifically, the disputed question is whether amounts held back by the finance companies and credited to accounts on their books designated "Dealer Reserve" accounts constituted taxable income to the accrual basis partnership in the years in which such amounts were thus withheld and credited, or in the years in which the partnership had a fixed right to such amounts.

The petitioners, husband and wife, filed petitions with the Tax Court appealing from the determination of income tax deficiencies for the taxable years 1952, 1953 and 1954 by the Commissioner of Internal Revenue, aggregating $47,020.60. (R. 57) The deficiencies resulted from the Commissioner's action in taxing the partnership for its fiscal years ended February 28, 1952, February 28, 1953 and February 28, 1954, amounts thus retained by the finance companies to which it sold its installment paper. (R. 24-25) The facts, as stipulated (R. 13-22) and as found below (R. 44-54; 75-79), may be summarized as follows:

Clifton E. Baird and Violet L. Baird, the instant petitioners, are husband and wife and are also equal part-

ners in a partnership doing business under the name of "Baird Trailer Sales" (hereinafter referred to as "the partnership"). The principal office and place of business of the partnership is Salem, Indiana. The partnership was organized about January 1, 1947, and has been engaged since that time primarily in the sale of new and used mobile homes, often referred to as house trailers. The partnership has always maintained its books and records and filed its Federal income tax returns on the accrual method of accounting. It uses a fiscal year ending on the last day of February. The partnership has always deducted bad debts under the specific bad debt charge-off method. The petitioners have always filed their joint individual returns on the cash basis and on the calendar year method. (R. 13, 14)

The partnership sold most of its trailers on the installment basis; the purchaser would execute a note for the unpaid purchase price, plus insurance, interest and, in some cases, finance charges, and give a chattel mortgage on the trailer as security for the payment of the note. These notes and security instruments were executed on forms furnished by the finance companies and banks with which the partnership had arrangements to discount such paper. (R. 14-17)

Being unable to finance all of such contracts during the taxable period, the partnership assigned most of such installment contracts and notes to various finance companies and banks which specialize in this type of installment paper in order to obtain cash for working capital. Accordingly, the finance companies were able virtually to dictate the terms under which they would agree to accept the paper. During the taxable period involved, the partnership assigned such contracts and notes to only three such finance companies, namely, Minnehoma Financial Company, Tulsa, Oklahoma; Michigan National Bank, Grand Rapids, Michigan, and Midland Trailer Fi-

nance Corporation, Cincinnati, Ohio. (These companies will be hereinafter referred to separately as "Minnehoma", "Michigan" and "Midland", respectively, and collectively as "the finance company" or "the finance companies".)

As each note or contract was transferred to a finance company, the company would remit to the partnership the balance due on the selling price of the trailer, less an amount which was entered as a credit on the finance company's books to an account designated "Dealer Reserve" or "Dealer Escrow". The amount thus credited on its books and not paid over by the particular finance company was governed by the provisions of the agreement of each finance company with the partnership. The finance companies required these amounts to be withheld to protect themselves against losses. (R. 16-17)

The agreement with Minnehoma was entirely in writing.[1]

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[1] The agreement with Minnehoma which was in effect during the taxable period involved, provided in part:

"6. The purchase price of each contract purchased by and assigned to Minnehoma hereunder shall be equal to 95% of the aggregate of the retail cash sales price of the trailercoach and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance.

"7. An amount to be determined by Minnehoma from time to time in its absolute discretion equal to not more than 5% of the aggregate of the retail cash sales price of the trailercoach and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance will be credited by Minnehoma to a special reserve account in the name of the Dealer hereunder as to each contract purchased by and assigned to Minnehoma hereunder, which account will be referred to as the "Dealer Reserve Account". In addition, Minnehoma may credit to such Dealer Reserve Account hereunder, but shall not be obligated

The agreements with Michigan and Midland were principally in writing.[2]

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so to do, one-fifth (1/5) on new trailers and one-sixth (1/6) on used trailers, or such other portions as Minnehoma may determine from time to time, of the finance charge paid or agreed to be paid by the purchaser in each contract. In addition to and without affecting any or all of its rights hereunder, Minnehoma may, at its option, charge against the Dealer Reserve Account any sums that the Dealer may at any time owe to Minnehoma in any connection whatsoever. In the event and at such time or times as the Dealer Reserve Account shall exceed 15% of the aggregate unpaid balances of all contracts purchased by and assigned to Minnehoma hereunder by the Dealer plus all contingent liabilities which, on the sole determination of Minnehoma, it may have with respect to such contracts, Minnehoma will pay such excess to the Dealers from time to time as determined by Minnehoma but not more frequently than once each month. In the event that and at such time as all contracts as shall have been purchased and assigned to Minnehoma by the Dealer shall have been paid in full and no sums shall remain unpaid thereunder and in the opinion of Minnehoma there shall be no contingent liability on the part of Minnehoma with relation thereto, Minnehoma shall pay to the Dealer the balance of the credit in such Dealer Reserve Account. Minnehoma's determination as to possibility of contingent liability shall be final and not subject to question by the Dealer." (R. 46-47)

[2] The written portion of the agreement between the partnership and Michigan provided in part:

"For Valuable Consideration, the receipt of which is hereby acknowledged, the undersigned hereby sells, assigns, transfers, and conveys unto Michigan National Bank, of Grand Rapids, Michigan, its successors, and assigns forever irrevocably, all of his, its, or their right, title and interest in certain sums of money now on deposit or that may hereafter be deposited in the Michigan National Bank, of Grand Rapids, Michigan, and identified and represented by Reserve account in the name of the undersigned in the Michigan National Bank.

"This Assignment and Transfer is made as collateral security for the payment of the direct and indirect liability of the undersigned to the said Michigan National Bank of Grand Rapids, Michigan, and to secure the payment of the several notes representing said direct and indirect liability and any

Under the Minnehoma agreement, Minnehoma was authorized to hold back not more than five per cent of the sale price of a trailer and credit such amount to a special reserve account in the name of the dealer, which account

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renewal or renewals thereof, or any installment payment or payments and to secure any obligation which may arise which the undersigned may owe to said Michigan National Bank of Grand Rapids, Michigan.

"In the event of default in the payment of said liability or any installment thereof, or any of the several notes at the time when same shall fall due or in the payment of the interest thereon or any part of the principal of said liability then the Michigan National Bank, of Grand Rapids, Michigan, at their election, notice of said election being hereby expressly waived, may apply the total of said sums of money represented by said Reserve account at the date of election or any part thereof to meet the default in the liability.

"Whenever the indebtedness secured hereby is paid in full the Michigan National Bank, of Grand Rapids, Michigan, shall reassign said sums of money represented by said Reserve Account along with all right, title and interest back to the undersigned.

"If in the opinion of the bank the undersigned dealer's account is in good standing, all sums in this reserve account in excess of ten per cent (10%) of the gross unpaid balance of all contracts outstanding on February 28 of each year will promptly be returned to the undersigned dealer." (R. 47-48)

The written portion of the original agreement between the partnership and Midland is set forth in two letters, written by Midland, dated 12/3 and 12/18/1951, and providing in part:

"* * * The retail paper is to be endorsed by you with recourse.

"Our advance on new trailer paper will be 97% on the unpaid cash balance and on used trailer paper, for 95% on the unpaid cash balance. The differentials of 3% and 5% will accumulate to provide you with a loss reserve. When this reserve fund exceeds 10% of your outstandings, the excess will be paid to you automatically." (R. 49)

On and after 6/10/52, the governing portions of the agreement between the partnership and Midland were contained in a letter from Midland dated 6/4/52, which provided in part:

"Beginning on June 10, we will set up a dealer profit reserve equal to 1% of the unpaid cash balance of each retail contract. This profit reserve will be derived from the

was designated "dealer reserve account". When such account exceeded fifteen per cent of the aggregate unpaid balances of all contracts assigned to Minnehoma by the partnership, plus all contingent liabilities which, on the sole determination of Minnehoma, Minnehoma might have with respect to the purchased contracts, Minnehoma agreed to pay such excess to the partnership from time to time as determined by Minnehoma but not more frequently than once each month. When all of the contracts were paid in full and no sums remained unpaid thereunder, and in the opinion of Minnehoma there could be no contingent liability on the part of Minnehoma with respect to any such contracts, then Minnehoma would pay to the partnership the balance of the credit in such "dealer reserve account". It was agreed that Minnehoma's determination as to the possibility of contingent liability would be final and not subject to question by the partnership. In addition to the holdback provisions outlined above, Minnehoma might credit, but was not required to do so, one-tenth on new trailers and one-twelfth on used trailers, or such other portions as Minnehoma might determine from time to time, of the finance charge paid or agreed to be paid by the purchaser under each contract. (R. 46-47)

Under the Michigan agreement, the "holdback" account was credited to an account designated "dealer escrow account". The controlling payment provisions were: "If in the opinion of the bank the undersigned dealer's ac-

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service charge and it will be paid to the dealer when the retail contract is paid out.

"Effective also on June 10, the dealer reserves of 3% on new transactions and 5% on used transactions, will be paid to the dealer when the contract is paid out. This procedure will be followed on all types of payoffs, including payment by the purchaser at maturity, anticipation by the purchaser or payment by the dealer in the cases of trade-ins or repossessions." (R. 49)

count is in good standing, all sums in this reserve account in excess of ten per cent (10%) of the gross unpaid balance of all contracts outstanding on February 28 of each year will promptly be returned to the undersigned dealer." (R. 47-48)

The original Midland agreement was basically the same as the Minnehoma agreement, except that under the Midland agreement when the dealer reserve account exceeded ten per cent, instead of fifteen per cent, payments to the partnership were to be made in accordance with the agreement. Under an amendment to the Midland agreement effective June 10, 1952, a dealer profit reserve account was set up on the books of Midland to credit an amount equal to one per cent of the unpaid cash balance of each contract to be derived from the service or finance charge. No amounts were to be paid to the partnership under this provision until each retail contract was completely paid out. Furthermore, under this 1952 amendment, the "holdback" amounts of three per cent on new trailer sales and five per cent on used trailer sales, would be paid to the partnership when the contract was paid out, rather than when a minimum balance was achieved. (R. 49-50)

The agreements of the partnership with each of the three finance companies contained the following common provisions:

(a) In the event the retail purchaser's contract became due and unpaid, the finance company could charge the account of the partnership designated "Dealer Reserve" with the unpaid balance, as well as with repossession losses;

(b) In the event the partnership had a matured financial obligation of any nature to the finance companies, the amount of such obligation could be charged to the partnership's account designated "Dealer Reserve"; and

(c) Each finance company could look to the balance in the account designated "Dealer Reserve" of the partnership to satisfy any default by the partnership on its guarantees and obligations to the finance company, as well as any default by the makers of the notes. (R. 17)

A typical trailer sale transaction is illustrated as follows:

Sales Price of Trailer	$ 5,545.00
Cash Down Payment (and/or Trade-in Allowance)	1,745.00
Balance Due Baird Trailer Sales	$ 3,800.00
VSI (Skip Insurance)) Credit Check) Insurance)	$ 420.00
Principal (Amount of Note)	$ 4,220.00
Financing Charges Paid to Finance Company	420.00
Balance Due Baird Trailer Sales	$ 3,800.00
Credited to Reserve of Baird Trailer Sales	190.00
Cash Paid Baird Trailer Sales by Finance Company	$ 3,610.00

(R. 18)

During the taxable years 1952, 1953 and 1954 the partnership received and reported in taxable income the respective total amounts of $1,217.94, $1,778.94 and $9,-141.39 from the finance companies out of the Dealer Reserve accounts. Such amounts were paid in part by Minnehoma, Michigan and Midland, and the remainder by companies with which the partnership formerly had done business, but with which it did no new business in 1952, 1953 and 1954. The total amounts withheld and credited to the Dealer Reserve account by Minnehoma, Michigan and Midland during 1952, 1953 and 1954 were $25,816.58, $29,560.54 and $29,660.49. In determining the instant tax deficiencies, the Commissioner reduced such total credits by the aforesaid reported amounts and thereby added

the respective net amounts of $24,598.64, $27,781.61 and $20,519.18 to taxable income of the partnership for 1952, 1953 and 1954. (R. 22)

During the years here involved, the partnership (by way of illustration) recorded the sale of a trailer and the sale of the note on its books and records as follows:

Sales Receipt Journal Entry.

Cash and/or Trade-in Allowance	$1,745.00	
Contracts Receivable—Finance Company	3,800.00	
Trailer Sales		$5,545.00

When the Finance Company remitted the check, the following entry was made:

Reserve—Finance Company	$ 190.00	
Cash	3,632.67	
Expense for Intangible Stamps	1.38	
Contracts Receivable—Finance Company		$3,800.00
Expenses (Credit Check)		24.05
Cost of Sales		$3,824.05
Cost of Sales	$3,824.05	
Credit Inventory		$3,824.05

From the date of organization throughout the years involved, the partnership was at no time delinquent in any payments due the finance companies and most of the trailer purchasers were paying their notes when due.

On its returns for the taxable years 1952, 1953 and 1954, the partnership deducted specific bad debts in the respective amounts of $1,203.75, $2,239.12 and $1,203.69. Unpaid amounts due the partnership for accessories, supplies and repairs constituted a portion of such deductions. The remainder consisted of advances by the partnership to make the trailer purchaser's payments due a finance company under the conditional sales agreement which the purchaser failed to make.

When a purchaser defaulted on his contract and note, the trailer was repossessed upon receipt of notice of default. The partnership always paid the finance company the unpaid balance due on such note and recorded

such payment on its books and tax returns as a purchase. Where defaults occurred on the notes payable to the partnership, the payments to the finance companies as a result of the defaults were included on the partnership's fiscal year 1952, 1953, and 1954 returns as part of cost of goods sold. On resale of the repossessed trailer, the receipts therefrom were reported as gross receipts.

During the years here involved, the finance companies were in such good financial condition that they were able to pay any accounts which might have been due and payable to the partnership out of the Dealer Reserve accounts.

As of February 28, 1952, 1953 and 1954, the accumulated balances in the accounts designated below and the amount unpaid on notes signed by the purchasers of the trailers and sold with recourse to the several finance companies were as follows:

Minnehoma Financial Company

	"Dealer Reserve Account"	*Unpaid Balance*
February 28, 1952	$16,311.73	$224,677.16
February 28, 1953	21,279.30	207,346.78
February 28, 1954	25,438.69	185,398.65

Michigan National Bank

	"Dealer Escrow Account"	*Unpaid Balance*
February 28, 1952	$20,187.55	Unavailable
February 28, 1953	18,993.01	$ 94,930.14
February 28, 1954	19,218.03	92,577.49

Midland Trailer Finance Corporation

	"Dealer Reserve Account"	*Unpaid Balance*
February 28, 1952	$ 3,572.39	$ 93,043.00
February 28, 1953	28,347.95	650,000.00*
February 28, 1954	39,065.43	760,879.00

* This figure is an approximation furnished by the corporation in letter dated April 18, 1957, since it made no analysis of unpaid notes as of February 28, 1953.

SUMMARY OF ARGUMENT

Income does not accrue until the right to receive an amount becomes fixed. The amounts withheld by finance companies and credited to Dealer Reserve accounts on its books are not accruable in the year of withholding because extreme contingencies rendered most uncertain the right of the petitioners to such amounts.

The agreements between the partnership and each of the finance companies severely restricted the right of the petitioners to the amounts withheld. Although each agreement had slight variances, all three agreements were identical in their basic provisions. The crucial provision of each agreement permitted payments to the petitioners only when the balance in the Dealer Reserve account exceeded a fixed percentage of the total unpaid amount on all the trailer contracts, or, under one agreement, until the particular trailer contract was paid out. Other restrictions in the agreements, such as the absolute right of the finance company to charge against the account any claims against the partnership, cause the withheld amounts, and the credited portion of the finance charge, to be within the control of the finance companies and, therefore, not accruable by the partnership.

The holdback and other restrictive provisions of these agreements were dictated by the finance companies to protect themselves against losses. The partnership was forced to acquiesce in these unfavorable terms in order to do business with the finance companies.

The credits in the Dealer Reserve accounts were not partnership assets.

Trailer contracts and notes were assigned by the partnership solely because of its immediate needs for cash funds, since the business would have been much more profitable if the partnership had been financially able to retain such paper.

ARGUMENT

Baird Trailer Sales, a partnership, correctly accrued and reported in taxable income the amounts to which it was entitled under its agreements with finance companies which had purchased its installment contracts and notes.

The sole issue in controversy is whether amounts withheld by finance companies acquiring installment paper from the partnership, of which the instant petitioners were the sole partners, and credited to accounts designated "Dealer Reserve" on the books of the finance companies, pursuant to agreements between the companies and the partnership, should be accrued as taxable income by the partnership (a) in the years in which the partnership became entitled to such amounts under the terms of the several agreements, as contended by the petitioners, or (b) in the years in which such amounts were so withheld and credited, as contended by the respondent. In certain instances a portion of the finance charge was credited to such "Dealer Reserve" accounts in addition to the withheld amounts.

A. *Income Does Not Accrue Until the Right to Receive an Amount Becomes Fixed.*

Under Sections 41 and 42 of the Internal Revenue Code of 1939, the accrual system of accounting has been recognized as a proper method of accounting for income. The instant partnership utilized this method.

It has long been well-settled that it is the right to receive and not the actual receipt that determines the year for inclusion of the amount in gross income under the accrual method. This principle was enunciated in the case of *Spring City Foundry Company* v. *Commissioner*, 292 U.S. 182, and also in the earlier case of *North American Oil Consolidated* v. *Commissioner*, 286 U.S. 417.

This principle has been uniformly applied in subsequent cases. Representative decisions include *Campana Corporation* v. *Commissioner*, 210 F. 2d 897 (C.A. 7th), *Albers* v. *Reinecke*, 92 F. 2d 781 (C.A. 7th), and *Commissioner* v. *Edwards Drilling Co.*, 95 F. 2d 719 (C.A. 5th).

In the more recent cases of *Dixie Pine Products Co.* v. *Commissioner*, 320 U.S. 516 and *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281, this Court reaffirmed the rule announced in its earlier accrual cases. Although these latter cases involved the accrual of deductions, rather than the accrual of income, the principles governing the year of accrual are basically the same. As this Court said in the *Security Flour Mills Company* case: "It is the year in which the right to receive has become final and definite in amount that becomes the proper year of accrual." Furthermore, a "strained construction in administrative efforts to accrue income, should be avoided." *Commissioner* v. *Edwards Drilling Co., supra.*

B. *The Amounts Withheld by the Finance Companies Are Not Taxable in the Year Thus Withheld Because the Partnership Had No Fixed Right to Such Amounts in View of the Extreme Contingencies Governing the Payment of Such Amounts to the Partnership.*

During the taxable period involved, the partnership assigned deferred payment paper to only three finance companies, namely, Minnehoma Financial Company, Michigan National Bank, and Midland Trailer Finance Corporation. Although the agreements between the partnership and these three finance companies had slight variances, they were substantially equivalent in their general provisions. The petitioners contend that, under all three agreements, the right of the partnership to the amounts withheld from the purchase price of notes was so contingent during the taxable period that such amounts

should not be accrued as taxable income in the years withheld by the companies. (The Commissioner has not contended that the three agreements are distinguishable.)

The agreements with all three finance companies contained the following common provisions:

(a) In the event the retail purchaser's contract became due and unpaid, the finance company could charge the account of the partnership designated "Dealer Reserve" with the unpaid balance;

(b) In the event the partnership had a matured financial obligation of any nature to the finance companies, the amount of such obligation could be charged to the partnership's account designated "Dealer Reserve";

(c) Repossession losses of the finance companies could be charged to the account of the partnership designated "Dealer Reserve";

(d) The ultimate balance in the account of the partnership designated "Dealer Reserve" after payment of all notes by the partnership to the finance companies was to be paid to the partnership; and

(e) Each finance company could look to the balance in the account designated "Dealer Reserve" of the partnership to satisfy any default by the partnership on its guaranties and obligations to the finance company, as well as any default by the makers of the notes. (R. 17)

It is clear that each of these agreements wraps in one tight package the dealer's sale of a trailer contract to the finance company. Each agreement orbits around two central purposes: (1) the intention of the finance company to control the trailer sales, and (2) the intention of the finance company to have discretionary authority over the "Dealer Reserve" account in which the partnership had only a restricted contingent interest, subordinate to certain conditions in favor of the finance company. An

analysis of each finance company's agreement with Baird Trailer Sales clearly discloses the ultimate fact that the partnership had no fixed right to the withheld amounts during the taxable period.

1. *The Minnehoma Agreement.*

The agreement provides that Minnehoma will finance only Spartan Aircraft Trailers. The trailer purchaser must complete a credit form supplied by Minnehoma; the dealer forwards this and two copies of a Dun & Bradstreet or Retail Merchant's Credit Report to Minnehoma. Each trailer contract must be on a printed form provided by Minnehoma. Both the financing agreement and the trailer sale contract provide that the balance owed by the purchaser is payable at the Minnehoma Office in Tulsa, Oklahoma. No payments are to be made to the dealer, except, of course, the down payment. Any other payments the dealer receives are held in trust for Minnehoma and must be forwarded immediately to Minnehoma. Minnehoma designates the amount of the down payment. (R. 27-35)

The purchaser may sign only one trailer purchase contract, and this contract must be delivered to Minnehoma. The dealer's assignment and guarantee to Minnehoma is on the face of the trailer sales contract. Minnehoma has the right to pursue collection efforts and to repossess trailers on delinquent accounts, or to call upon the dealer to do so, all expenses to be borne by the dealer. The trailer contract includes an unconditional guarantee by the dealer against any losses by Minnehoma, including loss of prospective profits. The purchaser executes no notes in favor of the dealer and no evidence of the sale is obtained except the original trailer contract forwarded to the finance company. After deduction of the down payment in cash or by trade-in allowance, two elements make up the amount the purchaser pays: (1) the selling price of the trailer, and (2) a finance charge, usually

five percent on new trailers and six percent on used trailers per year on the selling price less the down payment.

Under the agreement between Baird Trailer Sales and Minnehoma, the trailer sale contract must provide that the purchaser pay in monthly installments over a period of not more than sixty months for new trailers and thirty-six to sixty months for used trailers, the exact period depending upon the model. The "purchase price of each [trailer] contract purchased by and assigned to Minnehoma" is ninety-five percent of the balance of the purchase price of the trailer. Minnehoma agrees to reimburse the dealer for sales taxes, extras, filing and recording fees.

As to the hold-back, the agreement provides that "An amount to be determined by Minnehoma from time to time in its absolute discretion equal to not more than five percent" of the aggregate purchase price "will be credited by Minnehoma to a special reserve account in the name of the Dealer." No payments are to be made to the dealer from the reserve account until the total in the account exceeds fifteen percent of the aggregate unpaid amount on all the trailer contracts, plus an amount adequate to satisfy any contingent liability which Minnehoma, in its absolute discretion, might determine to be due on such contracts. There is a further limitation upon payment, in that the excess amounts are payable only *"from time to time as determined by Minnehoma."* (Emphasis supplied.)

In addition to the hold-backs in the reserve, Minnehoma *may* credit the partnership with a portion of the finance charge, a matter solely within the discretion of Minnehoma, there being no obligation to make such credits. It is subject, of course, to the same conditions as the hold-back, once it is credited to the dealer's reserve account. (R. 27-35)

In addition to the uncertainty created by Minnehoma's discretionary authority to withhold amounts adequate to satisfy any contingent liability, the contract sets forth other conditions which cumulatively, if not separately, make the dealer's claim to the reserve contingent or unfixed. For example, "Minnehoma may, at its own option, charge against the Dealer Reserve account any sums that the dealer may at any time owe to Minnehoma in any connection whatsoever." (R. 32) Under this provision, Minnehoma conceivably might charge against the account court claims, fanciful breach of contract claims, and claims having no connection with the specific amounts in the Dealer Reserve account. In other words, under this broad provision, Minnehoma might charge against the account claims for which Baird Trailer Sales might or might not be liable.

Moreover, even when all the trailer contracts have been paid in full, Minnehoma may still refrain from turning over to the dealer the amount in the reserve account until "*in the opinion of Minnehoma* there shall be no contingent liability on the part of Minnehoma with relation thereto," that is, on the trailer contracts. (R. 32) "Minnehoma's determination as to the possibility of contingent liability shall be final and not subject to question by the dealer." (R. 32)

Finally, the dealer unconditionally guarantees the payment of the entire amount on each trailer contact, which would include sums due on contracts the terms of which may be extended and altered by the finance company. On a trailer purchaser's default, the dealer agrees to pay the sum due or, upon Minnehoma's demand, to repurchase the contract for the entire amount unpaid under the contract. Since the unconditional guarantee includes the five percent reserved, insurance premiums for the full term, and the finance charge for the full term, the dealer guarantees the finance company against all loss, includ-

ing loss of anticipated profits. Thus, it is clear that under the basic agreement the dealer guarantees considerably more to the finance company than is withheld in the reserve on the sale. For example, at the close of the taxable year ended February 28, 1952, the amount of the Dealer Reserve account with Minnehoma was $16,311.73, whereas the total of the unpaid balances on the contracts of the purchasers of trailers was $224,677.16. The comparable figures for the fiscal years 1953 and 1954 are $21,279.30 in the Dealer Reserve account as compared to $207,346.78 of unpaid balances, and for the fiscal year 1954, the comparable amounts are $25,438.69 and $185,398.65. (R. 20-21) Hence, the partnership's obligations to Minnehoma by contract precluded the partnership from asserting any right to the amounts withheld and credited to the Dealer Reserve account during the taxable period involved.

It is thus apparent that on the credit sale of a house trailer, the purchaser, dealer and finance company each have obligations which are interwoven in a single three-party agreement. This agreement gives the finance company virtually complete control over a fixed percentage, usually five percent, of the unpaid purchase price. The finance company exercises its control by withholding this fixed percentage in a special Dealer Reserve account surrounded by various conditions precedent to payment. These conditions are contingencies which might bar indefinitely the dealer's right to receive payments from the account and which did, in fact, bar that right at all times during the taxable period when the amount in the account was below the required percentage.

2. *The Michigan National Bank Agreement.*

Although containing less detail in its provisions, the agreement between Baird Trailer Sales and Michigan National Bank is fully as restrictive as the agreement with Minnehoma. The Michigan National Bank agree-

ment provides that in the event of default in the payment of any installment of the purchase price, or any of the notes given by the trailer purchaser, the Michigan National Bank at its election has the option of applying the total of the amounts in the Dealer Reserve account to meet the default in the purchaser's liability. The agreement also provides that when the indebtedness is paid in full, Michigan shall reassign the amounts represented in the Dealer Reserve account to Baird Trailer Sales. The agreement also provides that "*If in the opinion of the bank the undersigned dealer's account is in good standing,* all sums in this reserve account in excess of ten percent (10%) of the gross unpaid balance of all contracts outstanding on February 28 of each year will promptly be returned to the undersigned dealer." (Emphasis supplied.) (R. 37-38)

It is thus seen that the Michigan agreement is fully as restrictive upon Baird Trailer Sales as its agreement with Minnehoma. The variances in minor details between the two agreements are of no importance in resolving the question of whether amounts withheld by the two finance companies must be accrued in the years of withholding.

3. The Midland Agreement.

Likewise, the agreement with Midland Trailer Finance Company contains similarly restricting provisions limiting the partnership's right to receive the amounts withheld by the finance company, plus the portion of the finance charge which were credited to the Dealer Reserve account, so that such amounts are not accruable in the year thus withheld, but only the amounts to which the partnership was entitled to receive, and did receive, during the years 1952, 1953 and 1954.

The original Midland agreement was dated December 18, 1951, and was set forth in a letter from Midland to

Baird Trailer Sales. One of the key provisions of the agreement reads as follows: "Our advance on new trailer paper will be for 97% on the unpaid cash balance and on used trailer paper, for 95% on the unpaid cash balance. The differentials of 3% and 5% will be accumulated to provide you with a loss reserve. When this reserve fund exceeds 10% of your outstandings, the excess will be paid to you automatically." (R. 39-40).

On June 4, 1952, Midland modified the above-quoted provision as follows:

> "Beginning on June 10th, we will set up a dealer profit reserve equal to 1% of the unpaid cash balance of each retail contract. This profit reserve will be derived from the service charge and it will be paid to the dealer when the retail contract is paid out.
>
> "Effective also on June 10th, the dealer reserves of 3% on new transactions and 5% on used transactions will be paid to the dealer when the contract is paid out. This procedure will be followed on all types of payoffs including payment to the purchaser at maturity, anticipation by the purchaser or payment by the dealer in the cases of trade-ins or repossessions." (R. 41)

In other words, under the modified agreement, the holdback in the Dealer Reserve account, plus the portion of the finance, or "service" charge, was to be paid to the dealer when the contract was completely paid out, rather than when the reserve fund reached a specified percentage of outstanding dealer liability. Hence, it is the petitioners' position that the basic controlling provisions of the partnership agreements with all three finance companies are identical for the purpose of resolving whether the withheld amounts are accruable in the years of withholding; the respondent does not contend to the contrary.

4. The Controlling Contingencies Prevent Current Accrual.

Under the rule that taxation is chiefly concerned with the substance, rather than the form, of the factual pattern involved, it is clear that the withheld amounts were not within the dominion and control of petitioners during the taxable period, except as to the amounts received from the finance companies, which have been reported in taxable income. The position of the Commissioner is the embodiment of "attenuated subtleties," an approach frequently rejected by this Court in numerous income tax cases.

As so well stated in *United States* v. *Maryland Jockey Club*, 210 F. 2d 367 (C.A. 4th):

> "* * * Federal income taxes are based on reality not form, on fact not fancy, on substance not seeming. * * *"

To accrue currently the amounts withheld by the finance companies, as respondent contends should have been done, would be to exalt artifice over reality. Such accrual would depart from the well-settled principles governing accrual of income.

Petitioners' position on this issue was adopted, and the Tax Court's view was rejected, in the first opinion of a Court of Appeals wherein this precise question was considered. In *Johnson* v. *Commissioner*, 233 F. 2d 952 (C.A. 4th), the factual situation was identical in all material respects with the factual situation here. As in this case, the taxpayer there was a trailer dealer, and two of the finance companies with which he did business during the taxable period were Minnehoma and Michigan National Bank under agreements which were identical with the agreements between Baird Trailer Sales and these two finance companies. In both cases, the finance companies credited reserves on their books to the credit

of the dealer and withheld the amounts of the credits from the dealer. In both cases the Commissioner sought to include such withheld amounts as accruable income in the years withheld.

In the *Johnson* case, *supra*, the Court of Appeals for the Fourth Circuit reviewed the various decisions dealing with the proper year of accrual of income under circumstances which most nearly approximated those of trailer dealers. As pointed out by that Court: "No case involving reserves withheld by finance companies from a trailer dealer or an automobile dealer has been decided by any United States Court of Appeals." (233 F. 2d at 957.)

The court thereupon gave consideration to the various cases which had dealt with accrual problems under similar circumstances in the following language:

> "These principles have been applied by other courts and by this court to postpone the accruability of various types of reserves where the taxpayer's right to receive the money was dependent upon some contingency: *Commissioner* v. *Cleveland-Trinidad Paving Co.* (6 Cir.), 62 Fed. (2d) 85 (percentage of the contract price for street paving retained under contract provisions by municipalities to guarantee maintenance of the paving for a stipulated period); *Keasbey & Mattison Co.* v. *U. S.* (3 Cir.), 141 Fed. (2d) 163 (reserve withheld by a finance company from an asbestos manufacturer which had guaranteed home owners' notes discounted by the finance company for applicators of the taxpayer's product); *U. S.* v. *Fidelity & Deposit Co.* (4 Cir.), 177 Fed. (2d) 805, 178 Fed. (2d) 753 (reserves required by law to be set up against unearned premiums and losses on risks reinsured with another company not authorized to do business within the state); and authorities cited in those opinions." (233 F. 2d 956, 957)

The Court of Appeals for the Fourth Circuit held that dealers' reserves are not taxable income until there is a

fixed right to receive them and that the fixed right did not arise until the year in which they became payable to the dealer in accordance with his contract with the finance company. The court further held that the right of the taxpayer to receive the amounts in the Dealer Reserve account was not fixed in the fiscal year when the amounts were withheld by the finance company.

The Court stated that "The pattern of each sale was a single transaction from the time the trailer was sold through the time the note was discounted by the particular finance company on whose forms it was executed."

Subsequent to the opinion in the *Johnson* case, *supra*, the Court of Appeals for the Fifth Circuit sustained the taxpayer in *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395 (C.A. 5th). The factual situation there was identical with the instant factual situation is so far as the Minnehoma agreement is concerned. Since no basic distinctions exist between the Minnehoma agreement and the Michigan and Midland agreements, this decision is squarely in point with the instant case. The Court held in the *Texas Trailercoach* case, *supra*, that the amounts in the Dealer Reserve account were contingent credits and, therefore, that they did not accrue in the taxable year when the finance company withheld them and credited them on its books to the taxpayer.

In reaching its decision, the Court used the following cogent language:

> "The closer a tax comes to giving effect to the economic realities, the more bearable it is as the price of national security and of civilization. *The real trouble in this case is that the taxpayer is asked to pay a tax on money he did not in fact receive and had no right to receive during the taxable year in question.* He may never receive it, but he is asked to deplete his cash in order to pay it. If compelled to pay, the more business he does—the worse off his cash position will be. *But, if a more realistic view*

is taken, the Government will not be deprived of any tax, because when the contingent credit materializes as a fixed, ascertainable claim or if payments are received from the reserve account, the taxpayer must then include the fixed claim or payments in his taxable income." (Emphasis supplied.) (251 F. 2d 403, 404)

As the Court pointed out in the *Texas Trailercoach* case, the finance company played a vital part in the transaction from the incipiency of each trailer sale. In effect, the finance company controlled each sale, passed on the credit risk, furnished the printed form, dictated the terms of each trailer sale, and was specifically designated as the party to receive the unpaid balance. As far as the trailer purchaser knew or cared about the transaction, his dealings were with the finance company from the moment the sale was executed. As the Court pointed out; "In a real sense, Minnehoma extended its credit to the trailer purchasers, and purchased the trailer contracts *for* the trailer purchasers, at least to the same extent that Bancredit Corporation 'merely discounted notes for applicators' in *Keasbey & Mattison* v. *Commissioner.*"

The court also pointed out that the finance company in truth and in fact exercised dominion and control over the amount held back from the purchase price and to which the trailer dealer was not entitled during the taxable year. As the Court stated:

> "The practical effect of Minnehoma being a party to the transaction from the beginning, is that the taxpayer did *not* receive the full sales price or its equivalent from the purchaser. Minnehoma stepped in and exercised dominion and control over five per cent. The Commissioner is mistaken in saying that the taxpayer in any event receives the full sales price and that the only risk is the risk in every credit sale that the trailer purchaser may default. Here, the taxpayer runs the risk that Minnehoma, ex-

> ercising complete discretionary control over the reserve account, 'at its opinion', may charge against the account amounts Minnehoma decides that the dealer may at any time owe in '*any connection whatsoever*', a determination that is not subject to question by the dealer."

The Court of Appeals for the Fifth Circuit emphasizes the illusory nature of the dealer's position by its statement that "The dealer does not have a fixed, ascertainable claim to the reserve at the time of the sale or holdback; he has a claim for some time in the future." Likewise, petitioners here had nothing more definite than a claim for some time in the future.

The case of *Keasbey & Mattison Co.* v. *U. S.*, 141 F. 2d 163 (C.A. 3d), is also applicable here, although its facts are not identical. In that case a reserve had been withheld by a finance company from an asbestos manufacturer which had guaranteed home owner's notes discounted by the finance company for applicators of the taxpayer's product. Specifically, the taxpayer had discounted notes receivable with a finance company for a charge of 7%, 2% of which was to be credited to a reserve account to be used in paying off discounted notes which were more than 60 days delinquent. The taxpayer assumed a maximum liability of 10% of the paper discounted and was entitled to receive annually the excess over its guaranty remaining in the reserve fund, as well as the balance remaining in the fund upon termination of the agreement. Thus, it is readily apparent that the basic provisions of this agreement are substantially equivalent to the basic provisions of the instant petitioners' agreements with Minnehoma, Michigan and Midland.

In *Keasbey & Mattison Co.*, *supra*, the court held that no part of the reserve was accrued income of the taxpayer during the taxable year involved. It was stressed that whether the taxpayer would ever acquire a fixed right to receive anything from the reserve fund was con-

tingent and unascertainable throughout the taxable year. Likewise, in the instant proceeding, whether the taxpayer would ever acquire a fixed right to receive anything from the accounts designated "Dealer Reserve" account was contingent and unascertainable throughout the taxable year, except for the amounts actually received from the companies. Such amounts, of course, were reported in taxable income. The court also stressed that the "reserves" credited on the books of the finance company could be diminished by charges against them for delinquent and unpaid notes. The same factual situation is present in the instant case.

The Circuit Court of Appeals for the Eighth Circuit and for the Ninth Circuit have joined the Third, Fourth and Fifth Circuits in rejecting this general position of the Commissioner and the Tax Court, *Glover* v. *Commissioner*, 253 F. 2d 735 (C.A. 8th) and *Hansen* v. *Commissioner*, 258 F. 2d 585 (C.A. 9th); whereas the Court of Appeals for the Sixth Circuit has joined the Court of Appeals for the Seventh Circuit in sustaining the Tax Court's view. *Schaeffer* v. *Commissioner*, 258 F. 2d 861 (C.A. 6th).

Petitioners urge that the basic weakness in respondent's position is his failure to evaluate adequately the degree of contingency to which the credited amounts are subject. Respondent correctly states that "What is a substantial contingency is basically a question of degree." (Commissioner's Brief, 54)

How substantial is the contingency; how seriously does it interfere with the domination over the income or true ownership therein? It has been held that a sufficient contingency existed to prevent accrual in the taxable year in the following cases: payments received, in 1930 and 1931, under an option to purchase property, which were to be applied upon the purchase price in case the option was exercised but which were to be retained in case the

option was not exercised, where the option was surrendered in 1933 (*Commissioner* v. *Virginia Iron Coal and Coke Co.*, 99 F. 2d 919 (C.A. 4th), cert. den. 307 U.S. 630); deposits received over a three-year period by the seller under an option for the purchase of stock where the option was forfeited at the end of the period (*Hunter* v. *Commissioner*, 140 F. 2d 954 (C.A. 5th)); payments received in connection with an option agreement where the nature of the payments, as purchase price or rent, could not be determined until a later year (*Birch Ranch and Oil Co.* v. *Commissioner*, 152 F. 2d 874 (C.A. 9th), cert. den., 328 U.S. 863); and advance payment upon the sale of real estate where the sale was subject to forfeiture in a subsequent year (*Baird* v. *United States*, 65 F. 2d 911 (C.A. 5th), cert. den., 290 U.S. 690).

Petitioners earnestly urge that the restrictive control of the finance companies over the withheld amounts was truly substantial, not fleeting or fanciful. These amounts were unavailable to the petitioners during the taxable period. Whether they would ever be available was extremely uncertain. The wide control possessed by the finance companies rendered petitioners' current income rights most doubtful. *Johnson* v. *Commissioner, supra; Texas Trailercoach, Inc.* v. *Commissioner, supra.*

It is petitioners' position that each trailer sale, execution of retail paper, transfer of the paper and entry of credits to a Dealer's Reserve account constituted a "single three-cornered arrangement involving the dealer, the purchaser, and the finance company." *Hansen* v. *Commissioner, supra.* The record is abundantly clear that the finance company was an integral part of the original sale transaction and that, clearly, the partnership could not have carried on its business unless the finance companies had furnished the necessary financing by purchasing its retail paper. Since respondent states in his brief (40-41) that "either approach [single-trans-

action hypothesis or two-transaction hypothesis] should lead to the same tax result," no further discussion of this point is deemed necessary.

It is also significant that the accrual-basis finance company pays income tax on the purchaser's contract only as it receives the payments from the purchaser, since there is no "right to receive" any finance charges from the purchaser in the event the purchaser prepays the contract or the item is repossessed. *Motor Securities Co., Inc.*, unreported memorandum opinion of the Tax Court of the United States, dated October 30, 1952.

In a related case, it has been held that a taxpayer on the accrual basis did not receive income through the crediting of a patronage refund credit to his account on the books of a cooperative where such credit was subject to diminution because of various contingencies specified in the agreement between the taxpayer and the cooperative. *Long Poultry Farms* v. *Commissioner*, 249 F. 2d 726 (C.A. 4th). The Commissioner has announced that he will follow the court decisions culminating in *Long Poultry Farms* v. *Commissioner, supra.* Rev. Rul. 57-358, 1957-2 C.B. 42. The issue involved in that case is almost identical with the issue in the instant case.

C. *The Holdback and Other Restrictive Provisions of the Agreements with the Finance Companies Were Dictated by Such Companies in Order to Protect Themselves from Any Losses.*

The terms of the various agreements with the finance companies were entirely forced upon Baird Trailer Sales by such companies. There was no opportunity for negotiation on the part of the partnership in order to bring about more favorable terms in such agreements. Mr. Baird testified that he had no opportunity to make any suggestions with respect to the provisions which should be contained in his agreement with the finance companies.

(R. 22-23) The partnership had no choice but to accept the company's terms if it hoped to discount its paper in order to obtain the cash most urgently needed in its business.

A vice-president of Midland testified that the hold-back provisions were inserted in the contracts with Baird Trailer Sales in order to protect Midland against any losses. (R. 26-27) An officer of Minnehoma testified to the same effect in the *Johnson* case, *supra*. Further, the agreements clearly reflect that the partnership was at the mercy of the finance companies in the arrangements which are involved in the instant case. The extreme contingencies with respect to the payments of amounts back to Baird Trailer Sales were created by the finance companies for their protection, not by Baird Trailer Sales.

It is obvious that the high risk element in the sale of house trailers severely limited the market for trailer coach paper and gave heavy bargaining leverage to financing institutions. As a result, the finance companies have come to exercise considerable control over a dealer's business practices and frequently participate in and police a dealer's sales.

D. *The Credits in the Dealer Reserve Accounts Were Not Assets of the Partnership.*

The credit balances in the Dealer Reserve accounts did not constitute assets of the partnership. The balance sheets of the partnership as reflected in its Federal income tax returns do not set forth the credit balances as assets. Furthermore, Clifton E. Baird, one of the petitioners, testified that he did not consider the balances in the Dealer Reserve accounts to be assets of the partnership and he did not include such balances in the financial statements of the partnership as prepared under his supervision and made available to appropriate

agencies, such as banks and other credit agencies, including Dun & Bradstreet. (R. 24-25)

From time to time the finance companies requested statements of the amounts of the balances in such accounts and also the amounts of the contingent liabilities of the partnership on notes and contracts sold to finance companies. When such information was requested, the partnership, of course, furnished it in order to continue to do business with the requesting company. Even when furnished to a finance company upon request, the credit balances were not reflected as assets in the balance sheet, but were only mentioned in a separate accompanying statement.

E. *Trailer Contracts and Notes Were Discounted by the Partnership Solely Because of Its Need for Immediate Funds.*

The helplessness of the partnership in its relationship with the finance companies is emphasized by the fact that the discounting of contracts and notes took place only because the partnership was in pressing need of funds. Mr. Baird testified that he would not have assigned any contracts or notes except that he urgently needed working capital in order to go forward with his business. (R. 23) The instant petitioners apparently were typical members of the new and growing trailer-dealer industry, who were experiencing an acute shortage of working capital in their efforts to survive and expand. The Commissioner's position would actually cause the dealer's *cash* position to become drastically worse as his sales increased.

It is obvious that the partnership would have made more profit if it had been able to retain the notes and contracts received from the purchasers of its trailers. If it had been able thus to carry on its business, it could have then realized not only the profit on the sale of the

trailer, but the not inconsiderable amounts which flowed from the finance charges and other "extras" into the finance companies.

F. *Reply to Commissioner's Argument.*

"II. The administrative practice"

Although the Commissioner argues (pages 35-39) that the consistent administrative practice of the Internal Revenue Service "carries substantial weight," it is significant that he has never attempted to incorporate his statutory interpretation in the Treasury Regulations. If he had felt strongly that his interpretation was correct many years ago, petitioners submit that the Treasury Regulations would have been appropriately amended.

"III. The nature of the transactions"

On pages 52-57 of his brief, respondent argues that the disputed amounts should be currently accruable because, if the trailer purchasers default in their payments, the taxpayers will obtain an ultimate tax benefit through the satisfaction of their "other obligations to the finance companies." (R. 82; Respondent's Brief, 57.) Petitioners urge that this contention is not applicable to the "year of accrual" determination. Respondent cites no authority for a purported principle that an accrual basis taxpayer must *accrue* currently as income amounts to which he has only contingent claims in the taxable year, simply because in some future year he *may* be entitled to a loss or bad debt deduction or offset. Accrual basis accounting has never recognized such a rule and it is not believed that the decisions of this Court or the lower courts support this oblique contention. It is still the "right to receive" the income in question and no other concept that determines the year of inclusion. *Spring City Foundry Company* v. *Commissioner*, *supra*; *Dixie Pine Products Company* v. *Commissioner*, *supra*; *Security Flour Mills Co.* v. *Commissioner*, *supra*.

CONCLUSION

Since the right of the instant partnership to the withheld amounts, and credited finance charges, was contingent and unascertainable during the taxable period and since the partnership might never receive such amounts at any time, the amounts in question did not accrue during the taxable period and the decision of the Court of Appeals for the Seventh Circuit should be reversed.

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APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. • • •

• • • •

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule*:—The amount of all items of gross income shall be included in the gross income

for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 42.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

§ 39.41-1. *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

§ 39.41-2. *Bases of computation and changes in accounting methods.* (a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall

be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See §§ 39.42-2 and 39.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see § 39.22(c)-5.)